DOW THEORY LETTERS INC.

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July 9, DJIA 1003.11; PTI 640; A-D Ratio -22.27
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CAPSULE RUNDOWN: Plusses: (1) On July 12 the D-J Industrials confirmed the new highs in the Transportation Average. (2) Bonds and Utilities and Financials have been strong. (3) Public still bearish as per odd lot selling and heavy mutual fund redemptions. Minuses: (1) No "follow through" on the upside after Industrials confirmed on July 12. (2) July 12 new Dow high occurred five months after last high (Feb. 24) in the Advance-Decline Ratio. In other words, A-D Ratio failed to confirm.

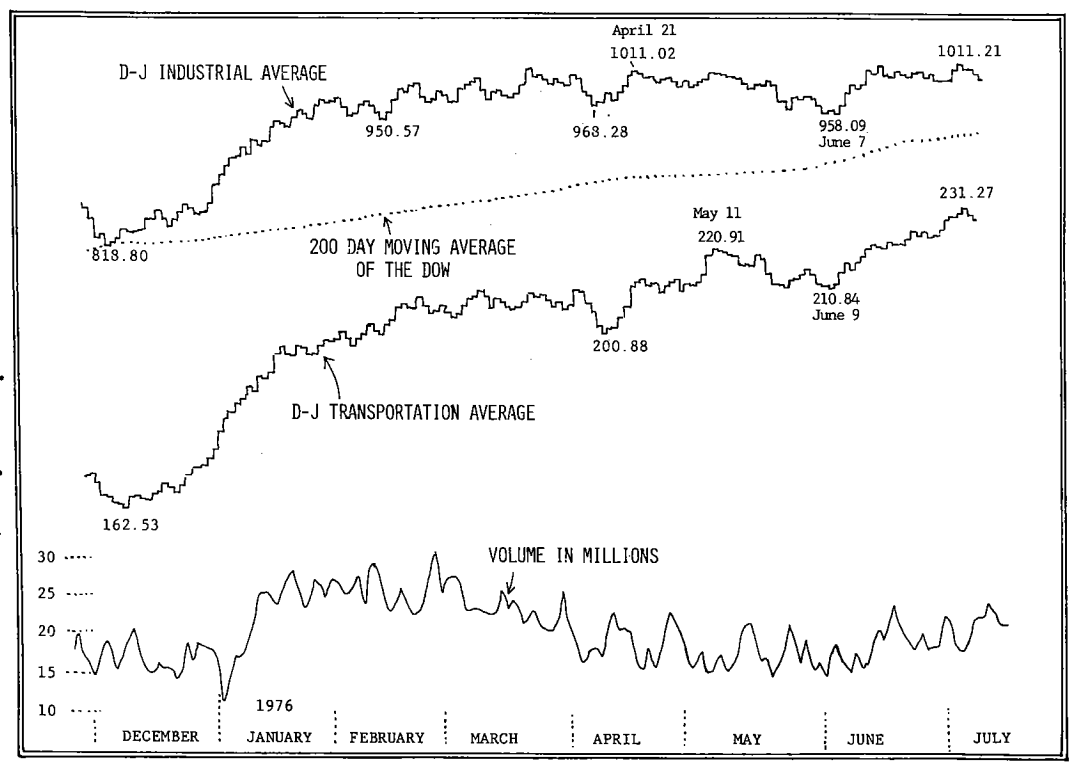
THE MARKET, PATIENCE, AND MY FINGER: Everything seems to have a plus side and a minus side, a thought which probably brings to mind the many amusing jokes about "the good news and the bad news." For instance, a few days ago, while attempting to pry apart a frozen block of vegetables with a carving knife, I "miscalculated" and thrust the knife clean through one finger and into the next. Aside from the pain and the long wait in a hospital emergency room, it was no earth-shaking event. The bad news was that it had happened at all and that I had been such an ass. The good news was that miraculously, I had missed the tendon and am here typing away two days after the event.

I am convinced that everything we do and everything that happens to us, happens for a reason. I don't believe in luck at all — not at all. The reason things "happen," I believe, is that we are supposed to learn from them. We are here on this earth to advance through learning and experiencing. I think the knife incident taught me that I must exercise much more patience. I tend to act before I think. If I can get that into my head, then a sliced finger and three stitches represent a small price to pay.

The stock market has provided all of us with a lesson in patience and fortitude here in 1976. I have been saying all year that we have had one overriding thesis to work with, and that thesis is that we are in a primary bull market. Now a primary bull market is basically a situation in which the long-term background for stocks, business and the economy is improving. Unfortunately, no economist can map out for us exactly how the improvement will come about. And no textbook can tell us exactly where to look or how to document the improvement.

But when the ocean tide is coming in, we don't demand that each new wave sweep nearer the shore than the last. It is enough to know that hour by hour the tide is pushing relentlessly higher. It should be the same with a bull market.

The stock market is a most extraordinary and exasperating creature. Although it is made by the minds and actions of men, it defies and deceives them to its last ounce of energy. Thus, the market is always faced with a problem. The problem is how to foil the most people. In a bull market, Wall Street's problem is how to climb higher while keeping the majority fearful, skeptical and on the sidelines. And in a bear market the problem becomes one of how to take stocks lower with the greatest number of stockholders hanging on (while attracting as many luckless new buyers as possible).



BREADTH-PRICE NON-CONFIRMATION: So the market, devil that it is, has now come up with the perfect formula for keeping us frustrated and worried. In Letter 668 (page 2) I discussed in detail the critical importance of the price-breadth relationship. I note that it was crucial for the A-D Ratio to better its bull market peak of February 24, 1976.

And what happened? On Wednesday, July 14, the A-D Ratio closed within a mere 14/100's of its February 24 high. One more semi-strong up-day would have been enough to provide

the long-awaited "new high in the A-D Ratio." But on Thursday, July 15, the market turned down, and the A-D Ratio backed away from that fateful February peak. The weakness carried into Friday, and as the market slipped off I found myself wondering whether the painful history of major price-breadth non-confirmations (as per Letter 668, which I suggest you review) is to be repeated again. It is simply too early to tell, but we'll have to be on our guard.

REVIEW: The story of this entire bull market, so far, has been one of grinding, plodding upward action. Through crisis after crisis, through non-confirmations, divergences and out-of-gear movements, through global droughts and interest-rate scares and political crises, the market pushes up. And that's the reason I have laid so much stress on the various broad, composite stock Averages. Perhaps better than anything else, they have reflected the upward path of the bull.

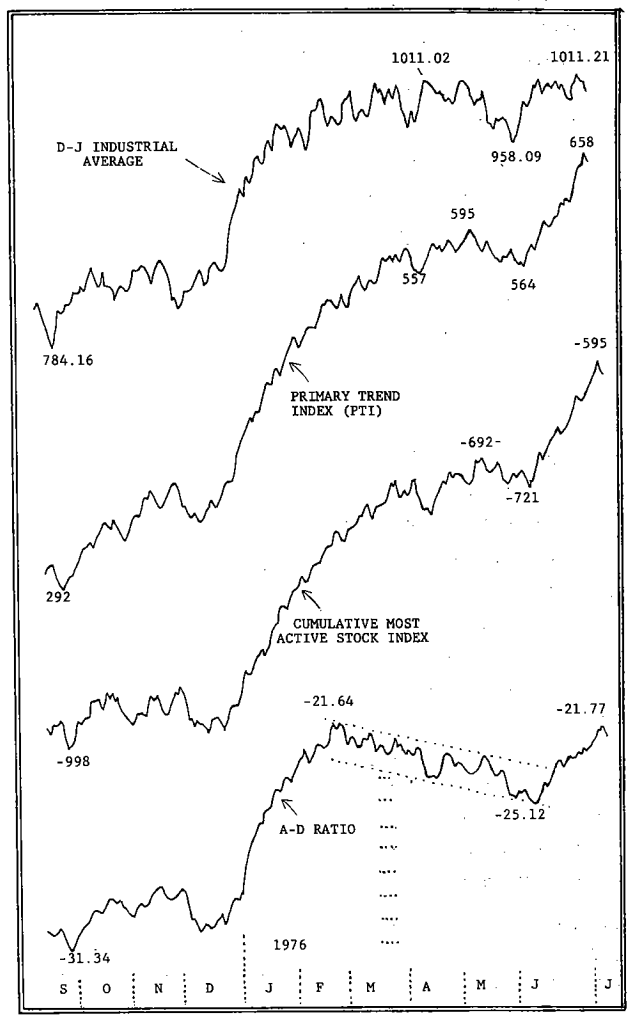
On Monday, July 12, the stock market put on quite a performance (see page 1 chart). On that day the D-J Industrials finally rallied to a new bull market high of 1011.21, thereby confirming the long series of new highs in the Transportation Average. From the standpoint of classical Dow Theory, the joint new July highs in Industrials and Transports re-confirmed the fact that we are in a primary bull market.

On the face of it, the rally to the July 12 Dow high seemed solid enough. Almost all segments of the market moved up in gear with the Dow. The D-J Utilities pushed to within a point of the 1976 high, while the other major Averages confirmed literally across the board. All five NYSE Indices (Industrials, Transports, Financials, Utilities, Composite) rose to new bull market highs. All four Standard & Poor Averages advanced to new '76 highs (Industrials, Rails, Utilities, Composite).

Of my various technical indicators, those two old faithfuls, the Cumulative Most Active Stock Index (CMAS) and the Primary Trend Index (PTI) both confirmed by rallying to bull market highs. What more could any market student demand?

Ah, that's where the old bull market gets sly and downright mean. Remember, Wall Street very seldom wipes all the haze off the crystal ball. On July 12, the day of the new Dow bull market high of 1011.21, the Advance-Decline ratio was still half a point below its February 24 high. That was enough to keep me on the edge of my seat. In the next two days the A-D came within a whisker of bettering the February peak, and then—the market sold off. Which leaves us in limbo once again.

Question: Russell, how do you read the whole situation now? How serious do you think the A-D non-confirmation is? Answer: The Dow has squeezed out a new high five months after the last A-D peak. Historically, new highs in the Dow which occur many months after the last high in the A-D ratio have tended to produce messy markets. In 1963 this same situation occurred, but it straightened itself out. The market advanced throughout 1964 and 1965. In most other instances, such as 1919, 1929, 1947, 1957, 1959, 1961, 1963, 1965 and 1972, long-lag non-confirmations between the Dow and the A-D produced trouble. I hope the non-confirmation of 1976 is of the 1963 variety.



Question: Holy cow, Russell, you cite one example of where a major price breadth lag turned out all right and eight instances that turned out rotten. What kind of odds are those? That's supposed to keep us bullish?

Answer: Look, I pointed out the possibility of this situation's occurring in Letter 668. All I can do is direct subscribers' attention to where to look and what is happening. I don't make the markets. I would love to have seen the A-D ratio blast up through its Feb. 24 peak last week. It refused. It stopped 14/100's short of the Feb. 24 high and turned down. If, over the next week or so, the A-D ratio breaks down badly, it could be a sign of impending trouble in the form of a long, trading range market (as per 1946-49) or worse.

On the other hand, if the market now gathers strength and the A-D ratio pushes up through its February 24 peak, we'll have a very bullish signal. Most of the previous time lag non-confirmations came late in their respective bull markets. The current lag non-confirmation has occurred in only the second year of this bull market. That's an observation with a plus in it. But in the final analysis, we'll have to let the market tell its own story. Our real job when the story is out is — to listen!

Question: Would you be selling some stock in here? How cautious would you be? Answer: I want to see more. I still want to give the bull market every benefit of the doubt. What I am watching now is the ability (or inability) of the A-D ratio to hold most of its recent laboriously-earned gains.

TICK ACTION: As long as we are watching the A-D so closely at this point, I thought that this would be a good time to introduce the tick volume (available at many brokerage houses that have automated quote machines). The ticks (which can be punched out any time during a trading session) show the number of stocks which have ticked up or ticked down during the day up to the time you punch the ticks out. Thus, theoretically the A-D could be down at a given time, but if the majority of stocks were coming back, ticks could be plus. The ticks often give advance indications of coming trends in the A-D ratio.

I have been watching tick indications for years, and I have more recently been running the tick differentials on a closing basis (after the market closes). The accompanying chart shows the closing tick figures for the NYSE on a 13-day moving average. This tick indicator has given very good, advanced indications of the broad direction of the market (and by the market I mean the A-D ratio and the various composite Averages).

Ticks hit a low below minus 3000 in December, 1975, then rallied up to a plus 2000. This corresponded with the recent buying panic. After a January-February consolidation, the ticks broke down, hitting a low point in late March, 1976. That was the worst of the 1976 action. Now this is most important. A bullish rising channel was formed after the March low. By mid-June the ticks climbed over the critical zero level—into plus territory.

This is also very important. The ticks are still plus today. If the ticks can stay within the bullish channel, I would be of the opinion that the A-D ratio is going to confirm by bettering its February 24 high! If the ticks turn down and fall out of the downside of the channel, we're going to have trouble and a poor A-D ratio pattern. I'll keep subscribers informed about the path of the tick indicator.

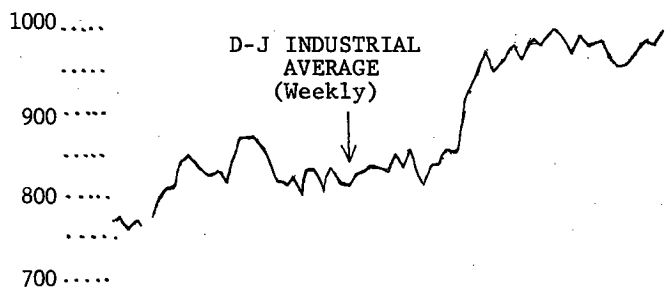
TWO STUDIES: I am presenting two studies which have proved particularly valuable to me during the confusing period of February to July, 1976. Both studies concern themselves with the character of the market, as opposed to the psychology of the market.

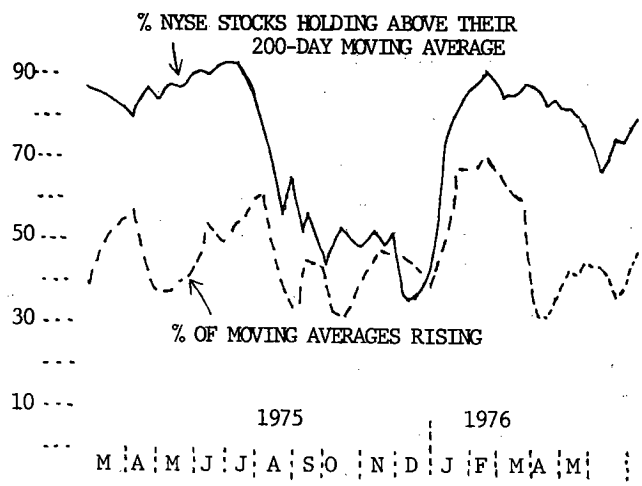
Character of the market studies have to do with breadth, movement, highs and lows, action. Psychology of the market studies have to do with sentiment, odd-lot action, short interest, specialist shorting, what the big money and the public money are thinking. I have leaned heavily towards the character of the market studies during the past three or four years. The reason I have done this is that most analysts have been zeroing in on the psychology methods, and I think that approach has been overdone. To put it bluntly, I do not think the psychology and sentiment studies have been working too well since 1973. On the other hand, the character of the market methods have been working.

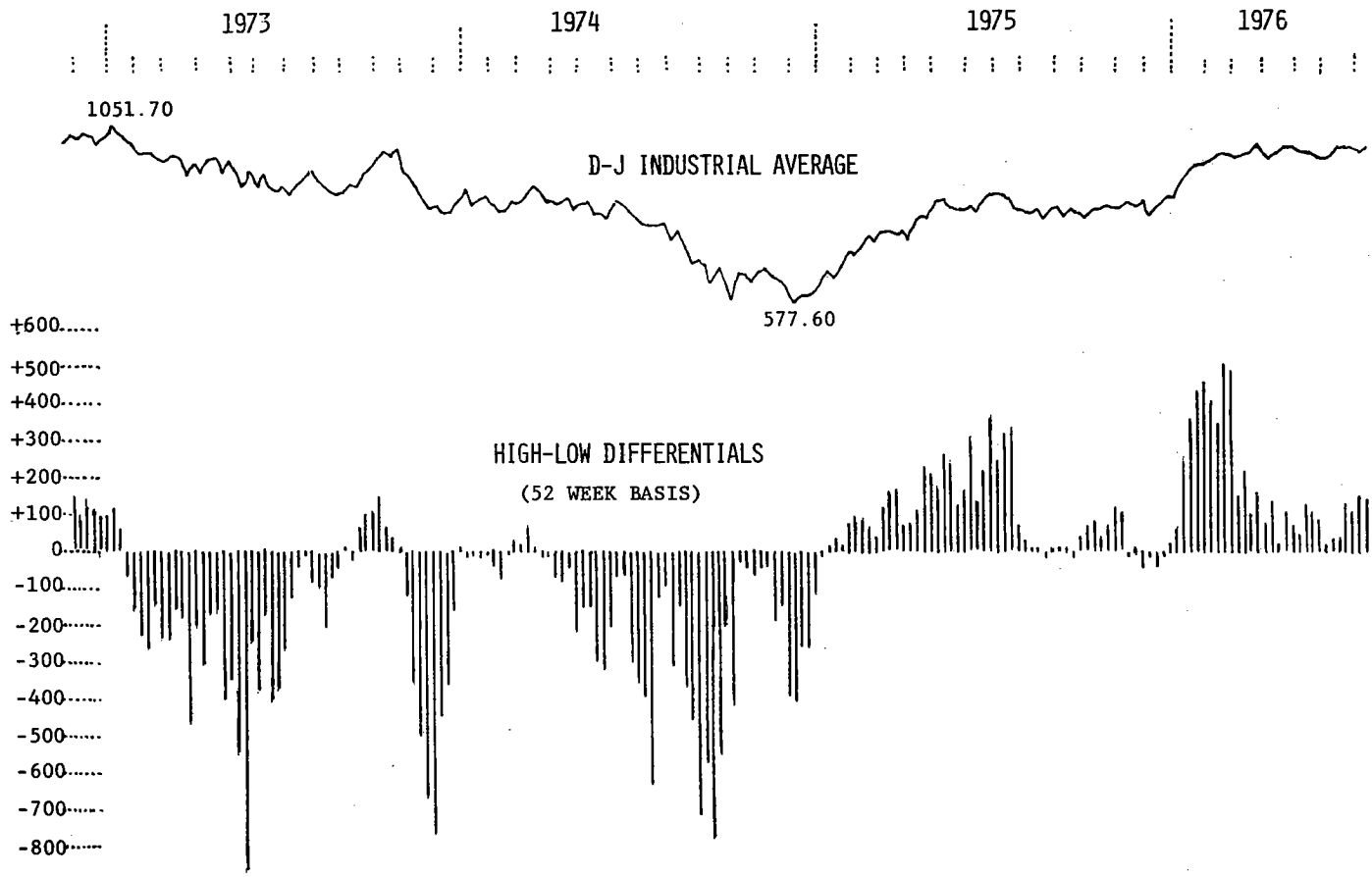
The first study I am presenting is based on figures released by the M/G Financial Weekly. Here we see the Dow Industrials superimposed on two indices. The two indices are (1) the percentage of all NYSE common stocks which are holding above their 200-day moving averages, and (2) the percentage of all NYSE moving averages that are rising.

This study is valuable in that it allows us to examine the broadness and depth of any given advance or decline. Which is another way of saying that the study allows us to study the number of stocks which are participating in any advance or decline.

Please turn to the chart. Note that last year, in July, the number of stocks holding above their 200-day moving averages (MA) topped







out at 60%. By October (three months after the top) the percentage holding above their MA's dropped below the critical 50% level, and by December the same index bottomed out at 36 %. What the chart is telling us is that in December, 1975, only 39% of all NYSE stocks had rising MA's and only 36% of all NYSE issues were holding above their MA's. This, then, was a typical bull market reaction, a reaction which lasted approximately five months.

Now let's compare the 1975 reaction characteristics with the 1976 situation. The peak of market strength in 1976 was undoubtedly seen in February. At that time 91% of all NYSE common stocks were holding above their MA's and 70% of all MA's were rising. By early April the percentage of rising MA's had plunged to 32%, its low for 1976. Thus, the 1976 low of 32% (referring to percentage of rising MA's) was exactly the same as the 1975 low. But the extraordinary fact is that three months have now elapsed since the April low and the percentage of stocks holding above their MA (solid line on chart) has never dropped below 65%.

The latest figures (July 9) show that both indicators have pushed well above their April lows with 80% of all NYSE common stocks now holding above their 200-day MA's. So here is another set of indicators which will help us to gauge the market condition as the difficult year 1976 works its way towards conclusion.

Now for the second study. This is based on a 52-week running tabulation of new highs and new lows for common stocks on the NYSE. The chart shows the differentials in these two figures. It is important to realize that these tabulations differ from the listed tabulations in your daily newspaper in one important respect. Dow Jones lists the highs and lows through to March of each year, and after March, Dow Jones drops the old calculations and starts from the most recent January again. But M/G Financial's calculations include all highs and for the most recent 52 weeks on a continuing basis (there is no annual cancelling out and beginning again).

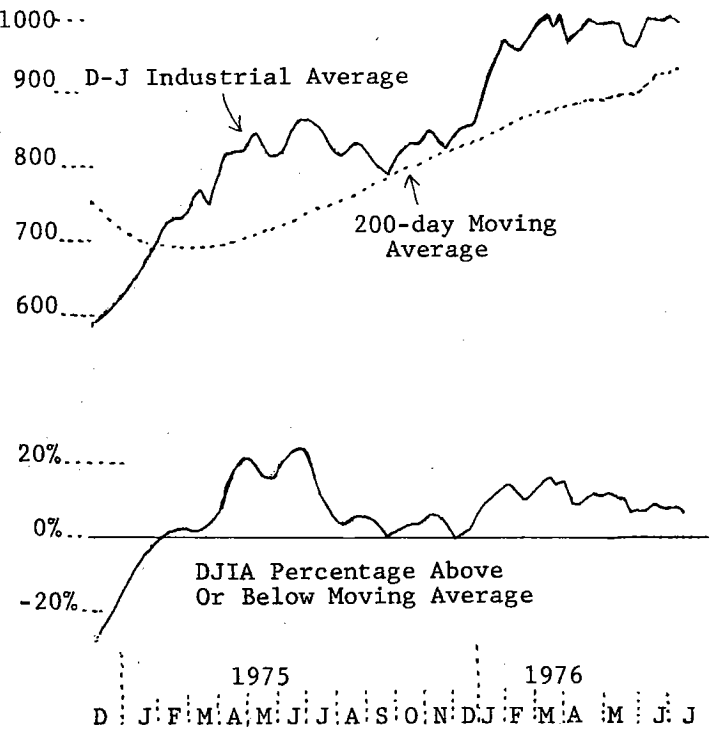
What I wanted to show on this chart (aside from an interesting historical perspective) is that unlike 1975, there has been no single week during 1976 in which new lows outnumbered new highs. The weekly differential figures have remained on the plus side throughout all the corrective processes of 1976. This has been a hopeful showing, so far. It will be a particularly good sign if the high-lows can remain on the plus side during the current still-confusing period.

(Note: Subscribers should save the reports so that when I refer to specific studies in later mailings, they will be able to review the studies and know what I am talking about. Also, I want to say that much of this report had to be rewritten in somewhat of a hurry. If I repeat myself, if my English is awkward in places, I'm sorry. It's hard to turn out great literature when Wall Street is breathing down your neck).

DOW 200-DAY MOVING AVERAGE: When studying this time-honored technical tool, we should remember that the 30 Dow Industrial stocks represent high grade shares, the kind of equities that seasoned investors are apt to buy. The 200-day moving average (MA) is simply a moving average of these 30 Industrials. Years ago, this indicator was known as the "investment line." The 200

day period is approximately nine months, a medium to longer term period in the market. Therefore, the 200-day MA gives us a good idea of the average price that investors are willing to pay for the 30 Dow stocks over the past nine months.

The relationship of the current price of the Dow to its own 200-day MA has proved both helpful and instructive over the years. I keep these figures on my chart in two ways. (1) A weekly Dow closing (Friday's) with the current 200-day MA. (2) A line showing how far the Dow is above or below its MA in terms of percentages (see accompanying chart).



It has been my experience that the Dow will hold above its MA during a bull market, except during the occasional secondary corrections. During corrections the Dow will often touch the MA, and in the most severe corrections the Dow will temporarily close below the MA. The great "buying areas" in primary bull markets come during those times when the Dow falls temporarily to or below the MA. During the 1949 to 1966 bull market, there were 13 major buy spots or areas in which the Dow broke below its 200-day MA.

As you can see on the chart, the Dow has not yet fallen below its MA in this entire bull market, although the MA has been touched twice, once in September, 1975 and again in December of that year. The "double retracement" to the MA seemed to have provided the technical steam of the 1975-76 buying panic.

The chart (lower section) shows that the Dow rallied to about 16% above its 200-day MA in March of this year. Ever since then, that percentage has been dwindling. The latest reading has the Dow about 6% above its MA (which now stands at 933). Whether the Dow is fated to come down and touch the still-rising MA remains to be seen.

I have been saying that a major technical problem facing this market is the fact that the Dow angle of rise from late 1974 to early 1976 was simply too steep. That angle had to be "flattened out." It has occurred to me that all the sideways movement of 1976, all the backing and filling, technical complications, non-confirmations and so forth may add up to solving that single problem. One way or another, we ARE seeing the angle of ascent (of the Dow) decrease as this bull market wears on.

CYCLES: I have been asked about cycles, my opinion of them, whether I believe in them. First, I know that cycles do exist in this world. But let's get this straight. Cycles always have to do with periodicity. If it's really a cycle, it will occur every year or every decade or every four months. I believe in cycles because I know they occur in this world. There are cycles all over the place; there's a cycle in the earth's revolutions, there are cycles in the life of the cicada insect, there are cycles in sound waves, and on and on.

What about the stock market? Ah, there's the rub. There may well be cycles in the stock market, but I'll be damned if I ever met anyone who has truly found them. I started in this business working with cycles, and I "cycled" my charts until I was blue in the face. And to tell you the honest truth, I never read or met anyone or anything that didn't "adjust" or fudge in trying to make the stock market cycles work.

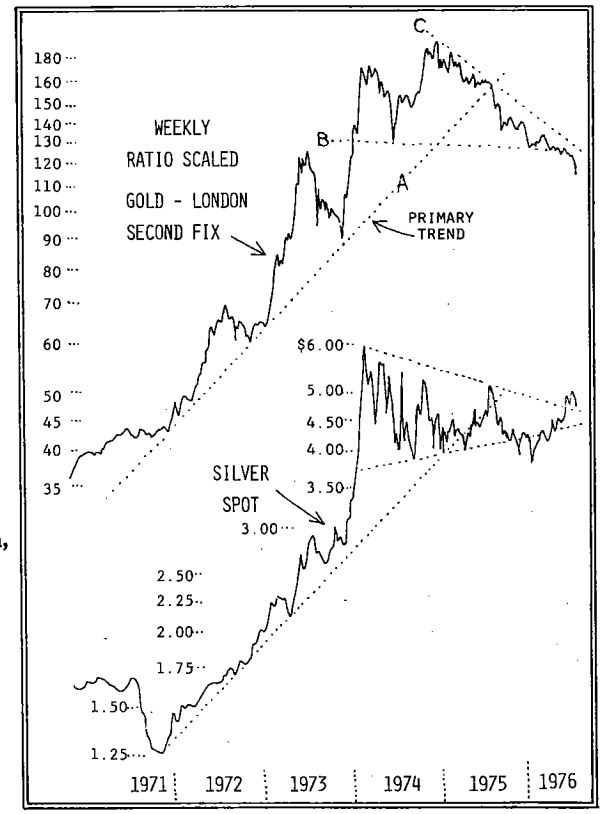
Procrustes was the old highwayman of Greek mythology who kept a bed. It was Procrustes' madness that he wanted everyone to fit that bed. If the person was too short, he would stretch him to make him fit. And if the luckless person was too long, this villain would cut off his legs to make him fit the bed. Unfortunately, every cycle's theoretician I have come across on Wall Street had the Procrustes complex. They are always moving the cycles up a bit or sliding them back to make them "fit." For this reason, I find market cycle theories fascinating, but just as apt to be deceptive as useful.

The cycle madness seems to be particularly prevalent now. Everywhere, people are charting their own bio-rhythms, messing with life cycles, figuring drought cycles, Kondratieff market cycles, earthquake rhythms. It's an obsession that I think will pass. Unless, of course, some Wall Street genius can find a cycle that works.

SYMBOLS: The stock market may hold THE key to what's coming up in the elections. IF the current price-breadth non-confirmation develops into something serious (and we do not yet know if it will), then the market will be telling us that business is going to be running "behind schedule" this fall and winter. That kind of action (if it materializes) is not calculated to help Mr. Ford's election chances.

A dull or disappointing business picture going into November (election time) would almost surely help Mr. Carter. Mr. Carter has picked ultra-liberal Fritz Mondale as his running mate, and it is therefore much clearer where Carter stands. The Carter/Mondale ("Grits and Fritz") team is another brand of the Great Society and the Brave New World. The Carter platform endorses "national economic planning," a "broad range" of new job programs, comprehensive and universal health insurance, a Federal takeover of

all welfare costs, Federal subsidies for just about everything including housing, education, transportation, electrification, on and on. Money for everyone, in short.



Now that the Democratic nomination is over, I note that many people are having second thoughts about Carter and that perpetual smile. They wonder if he might not be arrogant, they wonder if he is not too glib, and they wonder what the hell he is always smiling about. On the other side, bumbling, inarticulate Jerry Ford is the underdog, and Ronald Reagan doesn't tell people what they want to hear.

I am a firm believer in the thesis that people (under democracy) get what they want. On a deep level, they get what they want. Under Eisenhower, the people got a kindly father, a peace maker. With Eisenhower came the very beginning of great social revolt, the "beat generation," a stirring of giant new concepts, an era of innocence. Kennedy ushered in the "Soaring Sixties," an era which had promises but never did really soar. And along came rock music, the rise of blue-jeaned youth, an escalating of Viet Nam, and the hippy world. The grand illusions ended as abruptly as did the Kennedy years.

Next came Mr. Johnson and the rise of wheeling and dealing. But the way to heaven is a straight path, not a circular one, and Lyndon Johnson was a manipulator down to his bones. The Viet Nam war grew to fiasco proportions and youth turned to drugs. The US as a nation was growing schizophrenic, split on every issue. So along came our first truly schizophrenic President, Mr. Nixon. On the outside, Mr. Nixon was our "law and order" President, along with his iron fisted, no nonsense Vice President, Spiro Agnew. Behind the facade lay deceit and a brand of insanity best described as paranoidal. The only ultimate power evil has is to destroy itself, and the Nixon Presidency went down in a destructive collapse that shocked the world.

Next came Mr. Nixon's choice, Gerald Ford. To me, Ford represents "the impotent man who means well." Ford would like to do a good job, but he keeps tripping, stumbling, putting his foot (and both hands) in his mouth. The average American feels impotent regarding the Government today. It's not "his government," as it used to be, it's "THE government." It's "What are they going to do to me next?" and "How am I going to get pushed around this year?" So we have Mr. Ford, a symbol of our impotent, helpless feelings as we reel about like cogs in a monstrous out-of-control government machine.

Now comes Carter, the unknown. He could be the man on a white horse and he could be a monster. He could be "The Omen" or "Mrs. Carter's Baby" or "The Southern Exorcist." That smile could be angelic or demonic. We can't tell. Should we try him, should we take a chance, we wonder? We sense something ominous—or is it good...or, we just can't really figure....

GOLD & SILVER: One of the things we can not do in this business is kid ourselves. When you start telling yourself that "two and two equals five" in the investment business, you might as well pack it up, gather your remaining change and head for Vegas. At least you'll have a good time playing with your money there.

As we study this semi-log chart (plotted each Monday) we must recognize that gold is breaking down again. The primary trendline of gold (A on chart) was broken in mid-1975, and the implications of this were discussed at the time. The bearish descending trendline (C) was formed. Gradually, the scope of the gold top was seen as a massive "head and shoulders" top was traced out by the action of 1974 to 1976. The support line (B) was drawn at the 124 level.

Over the past week the second shoe fell. Coincident with the second IMF gold auction, gold dropped below the support at B and plunged to the 114 level. Perhaps acting in sympathy, silver sank back to the 4.75 area, well within the massive triangle formation as shown on the chart. Veteran chart readers know that when the price movement extends out towards the end of a triangle (as silver has), the strength of a move is often dissipated. This may be the case with silver as it moves towards the very apex of the triangle. Personally, I'm sitting with the small percentage of gold coins which I own.

LATE MARKET NOTES: With gold breaking down, with the market stalling, with bonds and Utilities showing superior relative strength, one has to wonder whether we're not looking at the forces of deflation (rather than those of inflation, as everyone seems to think).....I never have cared for "near misses" in the market, and the near-miss of the A-D Ratio (failing by a hair to better its Feb. 24 peak) bothers me. The next market rally may tell us an important story. If the A-D figures look sluggish, particularly in the face of perhaps a new Dow high above 1011.21. I'm not going to like it. In fact, I would then suggest some lightening up on stocks. We're in a very delicate and touchy area here, and I don't want my subscribers to get caught in a potential breadth collapse. So let's remain hopeful—but at the same time let's be watchful and careful!

Next mailing: July 30th